United States Senate Budget Committee

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SBC Staff Analysis Of CBO's Updated Budget And Economic Outlook

The Budget Outlook

According to CBO's updated budget projections released today, the federal government is on track to spend $3.5 trillion in the fiscal year ending September 30. Tax collections will total $3.0 trillion, resulting in a deficit of $506 billion. This estimate is $14 billion above CBO's April estimate of $492 billion, and is the net effect of lower revenues of $26 billon and lower spending of $11 billion (difference due to rounding).

Spending will grow by 65 percent between 2014 and 2024 by CBO's estimate—an annual average growth in spending of 5.2 percent. **Growth in baseline spending will be significantly higher than both the forecast 2.3 percent inflation rate and the 4.5 percent average rate of economic growth** (as measured by nominal GDP, which includes growth due to inflation). Revenues, by contrast, are projected to grow only slightly faster than the economy, resulting in a steady increase in the deficit over the decade.

By 2024, CBO projects that the annual deficit will double and again will approach $1 trillion. Cumulative deficits over the budget window total $7.2 trillion, with spending totaling $47.4 trillion and tax collections totaling $40.2 trillion.

Gross federal debt in CBO's baseline is projected to increase from $17.8 trillion at the end of this year to $26.5 trillion at the end of 2024—an increase of $8.7 trillion (49 percent). On the day President Obama took office, the total federal debt stood at $10.6 trillion. CBO again notes that, absent a course change, "the large and increasing amount of federal debt would have serious negative consequences," including increased spending on interest, restrained economic growth, and the loss of financial flexibility to address unexpected challenges the nation may face.

Spending growth is primarily concentrated in entitlement programs and interest on the national debt. Spending for mandatory programs (such as Social Security, Medicare, Medicaid, and federal subsidies for health insurance under Obamacare) will grow by 72 percent over 10 years, while interest on the debt will more than triple to $799 billion (up from $227 billion today). Outlays for annual appropriations on items such as the military, courts, and prisons will increase by 18 percent over 10 years, largely because CBO assumes that such spending will not exceed the statutory discretionary spending limits established by the Budget Control Act.

Refundable health insurance subsidies, exchanges, and related spending required under the Affordable Care Act (ACA) are expected to increase eightfold to $137 billion (up from $17 billion today) as the program becomes fully operational over the next decade. Medicaid, the eligibility for which was expanded under the ACA, will grow by 87 percent, while Medicare will grow by 72 percent. **Gross Medicare expenditures will exceed $1 trillion annually beginning in 2023**. Social Security benefit payments will grow by 78 percent, **exceeding $1 trillion annually beginning within just four years**. As noted, net interest costs rise sharply and will exceed the costs of national defense in 2023.

The most noteworthy change from CBO's prior budget outlook is the agency's projections for net interest spending. CBO still expects that interest rates will rise—but now to lower levels than previously forecast, to 4.7 percent for the 10-year note, down from 5.0 percent. This change in assumptions reduces deficits by $469 billion over 10 years, by itself explaining the $422 billion reduction in projected baseline deficits relative to CBO's April estimates. (The degree of this change underscores how dramatically fluctuations in interest rates can affect the government's obligations; if interest rates were to rise more than projected, deficits could be much worse.) Other noteworthy changes include a reduction in income tax collections of $259 billion over 10 years because a slack economy results in lower projections of taxable personal income, which is largely offset by expectations of slightly lower spending across a broad array of federal programs.

<u>The Economic Outlook</u>

The principal takeaway from CBO's latest economic forecast is the re-emphasis of the persistent economic damage caused by the recession. CBO argues that the recovery has not completely offset the damage done to the economy by the recession, which in turn has lowered potential output over the entire forecast horizon. Labor markets are weaker in the long run, the recession will leave the capital stock permanently smaller, and lower demand for goods and services plus labor market slack has reduced total factor productivity over the forecast horizon. Taken together, potential output from 2017 through 2024 will be 1.75 percent lower than otherwise: 0.7 percentage points from lower hours, 0.6 percentage points from lower capital services, and 0.5 percentage points from lower total factor productivity.

In the short run, however, CBO expects relatively stronger economic performance by 2015. The agency has significantly reduced its 2014 forecasts, but remains optimistic for the three years thereafter. On a calendar year basis, CBO's February forecast of real GDP was 2.4 percent over 2013. That forecast has been reduced to 1.5 percent. However, the forecast for 2015 has remained virtually unchanged: 3.3 percent in February and 3.2 percent in August. (Since the recession ended, forecasters including at CBO and the Office of Management and Budget have consistently predicted that a robust recovery is just around the corner.)

CBO expects the largest contributor to stronger growth to be business investment, which should add 0.9 percentage points to the GDP growth rate in 2015. This assumption appears optimistic, however, in view of the tax-induced flight of businesses and the failure of manufacturing to revive, even with lower energy costs.

The stronger growth forecasts also appear problematic when viewed from CBO's rather pessimistic outlook for labor markets. For instance, the agency's 10-year average labor force participation rate is now 61.93; in February it was 62.11 percent. The 2015 rate goes from 62.9 in the February forecast to 62.7. Even though CBO expects the unemployment rate to slowly decline, the small decreases in the rate after 2015 will be due entirely to decreases in the labor force participation rate.

CBO continues to see considerable slack in labor markets, which they largely attribute to the slow recovery. However, part of that slack is due to structural changes in labor markets stemming from the acceleration in retirements and the decay of skills among the long-term unemployed. **They also note that employment growth has been more heavily dominated by part-time work than normally is the case during a recovery**. This high level of part-time employment has contributed to the slow growth in hourly wages.

It is important to note that these changes in the size of the labor force relative to the civilian population lead to CBO's assumption of a static or declining tax base in wages and salaries. Also, the tax base forecast for corporate profits may be inconsistent with CBO's forecast of an acceleration in domestic business investment.